ComEd/Exelon's Performance Under the Illinois Electric Service Customer Choice And Rate Relief Law of 1997 and Beyond

Prepared for the Citizens Utility Board
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Introduction

This report summarizes an independent study of ComEd and Exelon's financial performance under Illinois' 1997 electric industry restructuring act.[1] Using standard methods of financial analysis, the study considers past investor and corporate performance during the transition period that was established by the 1997 Act.[2] The study also projects Exelon finances in a post-transition period environment using publicly available data from Exelon financial presentations. The study demonstrates that ComEd investors have dramatically outperformed alternative investments during the transition period; that Exelon has the best profit statistics in the electric utility industry; and, that it will continue to maintain robust earnings through the end of the decade, even if rates are reduced.

Three primary findings of the study include:

(1) Exelon's shareholder's are currently receiving a 21 percent return on their invested equity ("ROE.") This is about double the profit margin that regulatory commissions typically allow utilities to earn on their investment and the highest return of any electric utility in the country.

(2) Since 1997, ComEd/Exelon's investors have dramatically outperformed alternative investments and have obtained four to six times more value from dividends and increased stock price than the $3 billion that residential ratepayers have received in lower rates mandated by the act.

(3) Exelon does not need any rate increase to remain financially healthy. The company would post extremely high profit levels through 2012 even if rates were reduced by 5 percent.

The study of ComEd and Exelon finances consists of three components. First, the analysis tracks changes in the economic position of investors and ratepayers using information published in financial reports.[3] This part of the analysis demonstrates that shareholders have earned incremental profits on their stock investment of more than $18 billion since 1997, compared to $3 billion that residential consumers have saved as a result of the rate reductions mandated by the act (as quantified by Exelon in August, 2005). The stock price analysis shows that after accounting for alternative investments that could have been made, investor value ranges between $13 billion to $17 billion.

Second, the study reviews key financial performance measures of Exelon, a corporation that earns almost all of its revenues from assets that were once regulated. To evaluate the financial status of Exelon, two basic profitability ratios are tabulated for publicly traded companies in the electric utility industry. The two ratios include the value investors attribute to investor capital relative to the amount of invested capital -- the market to book ratio -- and the return on equity.

[1] The Electric Service Customer Choice and Rate Relief Law of 1997. (220 ILCS 5/16-101 et seq.)
[2] The Author has worked for utility companies, financial institutions and regulatory commissions as well as consumer groups. His experience includes working on ComEd rate cases at the ICC Staff while nuclear plants were being constructed; testimony for government entities relating to various deregulation plans offered by ComEd; analysis for the City of Chicago relating to potential municipal acquisition; direct involvement with the deregulation law in 1997; testimony and substantive involvement in ICC cases involving delivery services, declaration of competitive service and other cases.
[3] These reports included financial statements and stock prices from SEC 10-K reports published by Exelon and Unicom since 1994.

The analysis demonstrates that even without future rate increases, Exelon has achieved the highest return on equity and market to book ratio in the entire utility industry.

Third, the study analyses Exelon's prospective financial condition with a financial model to project future profits and cash flows. Using the financial model, alternative scenarios are constructed assuming (1) rates are driven by market prices and, (2) continuation of bundled rates. The bundled rate scenarios include a fixed rate scenario and a scenario in which rates are reduced by 5 percent in 2007. The financial modeling analysis demonstrates that use of market prices to drive retail rates is equivalent to substantial Exelon rate increases (more than $500 million in 2007 increasing to more than $1 billion per year.) These rates increases bolster Exelon's financial performance. More importantly, the financial projections demonstrate that Exelon would remain a very healthy company with returns far exceeding the industry norms without any rate increase, or even a 5 percent rate reduction.

Historic Stock Price Analysis

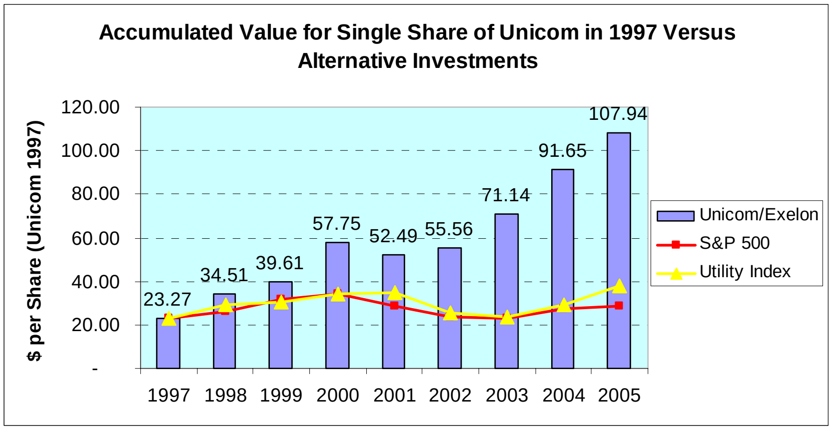
Comparison of the residential rate reductions with amounts realized by shareholders

To consider the value realized by ComEd investors, this study examines the performance of a share of Unicom since 1997. The study tracks shareholder earnings from the receipt of dividends; reflects shares exchanged from the merger with PECO in 2000; and accounts for the effect of Exelon's stock split. The results of this analysis of a single share are aggregated over the total 217 million Unicom shares that were outstanding in 1997.

The net value realized by investors depends on the alternative investments that could have been made in 1997. The study therefore compares returns from a Unicom share with alternative investments that could have been made in stocks, bonds or mutual funds. Once investor returns have been computed, the study contrasts the net amount earned by investors with the change in value of residential revenues caused by changes in rates since 1997.

The graph and table below illustrate that a hypothetical 1997 share in Unicom originally worth $23 would have provided an investor with an increase in value of $68 per share along with $16 per share in dividend payments.[4] Because of dividends and share increases, the original investment would ultimately be worth $108 (without accounting for re-investment of dividends.) This increase in value is equivalent to making an investment that generates a compound annual rate of return of 24 percent each and every year since 1997. The graph below also shows that the same $23 invested in a mutual fund consisting of the S&P 500 or a fund made up of stocks in the Dow Utility index would result in returns nowhere near the $108 earned from Unicom. These alternative investments in the S&P 500 and the Dow Utility index would have produced only $29 and $38 respectively. Finally, had the initial Unicom investment earned a rate or return equivalent to the returns granted by regulatory commissions to utility companies, this investment would have yielded $48 from dividends and share increases.[5]

[4] The analysis accounts for the share exchanges associated with the PECO merger as well as the extra-ordinary dividend that was paid to Unicom shareholders.
[5] The source of the granted regulatory returns is from ComEd testimony in its current delivery service rate increase case.



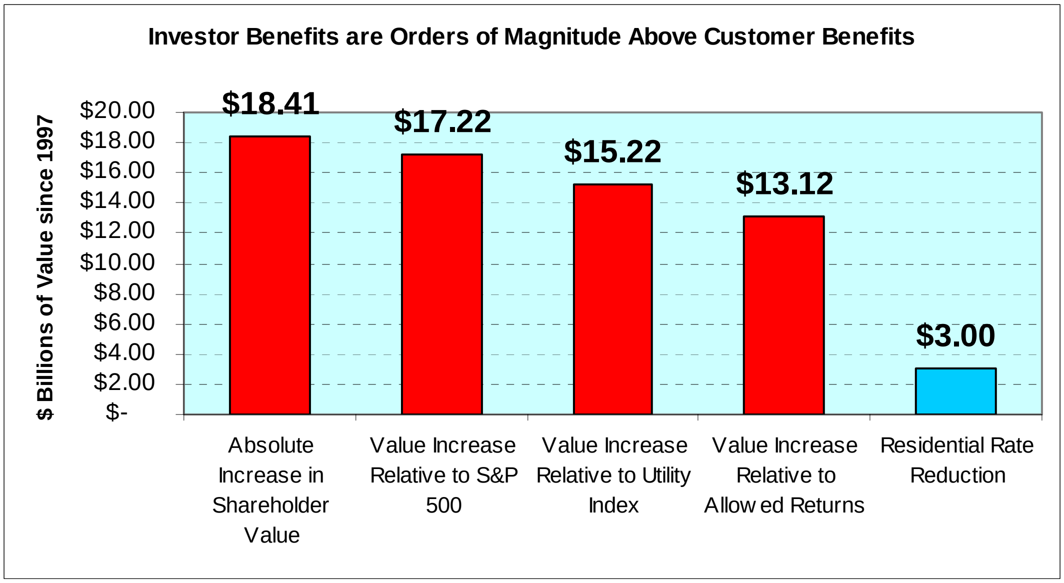
To consider the position of investors and ratepayers relative to where they were a decade ago, returns for the single share of Unicom stock were aggregated to determine the value of the 217 million shares outstanding in 1997. As a group, the accumulated profit to investors over the period from the end of 1997 through today totals $18.41 billion. (This is simply the absolute profit of $85 on one share – the $108 per share ending value minus the $23 per share beginning value –summed over the 217 million shares outstanding in 1997.) By assuming the group of Unicom investors could have made alternative investments, we can compute the net profit realized by all of the shareholders. To do this, the profit that would have been realized on these alternative investments is subtracted from the $18 billion generated from the Unicom investment. The net amount that investors would have realized from owning a Unicom share over and above the other investments ranges from $13 billion to $17 billion as shown in the table below.

Absolute Value and Value Relative to Other Investments Realized by Investors Since 1997

	Exelon	S&P 500	Utility Index	Utility Allowed Returns
Beginning 1997 Share Value	$ 23.27	$ 23.27	$ 23.27	$ 23.27
Dividends per Share	$ 16.42			12.80
Share Price Increase	$ 68.26			11.56
Ending Value per Share	$ 107.94	$ 28.76	37.98	47.62
Total Increase in Value per Share	$ 84.68	5.50	14.71	24.36
Shares Outstanding in 1997	217,468,182	217,468,182	217,468,182	217,468,182
Value to Investors in $ Billions	**$ 18.41**	$ 1.20	$ 3.20	$ 5.30
Value Increase Relative to Alternative ($ Billions)		**$ 17.22**	**$ 15.22**	**$ 13.12**

As a ComEd ratepayer, one could compute changes in the value paid for a kilowatt hour of electricity in a similar manner. Since 1997, the per kilowatt hour price of electricity for ComEd's residential customers in Illinois has been reduced by 15 percent in 1998 and an additional 5 percent in 2002.[6] Exelon has performed this calculation and derived that the value of the residential rate reduction relative to 1997 rates is $3 billion.[7] A comparison of the residential rate reduction with the gross and net investor benefit over the same period is shown in the chart below. The chart demonstrates that investors received four to six times the value of the rate reduction realized by residential customers depending on the assumption made with respect to the alternative investment.

[6] A 15 percent reduction became effective in August 1998 and another 5 percent reduction became effective in October of 2001.
[7] This number is presented in an investor analyst presentation made by Exelon to the financial community when it reacted to the appointment of Marty Cohen to the ICC.



The study identified many reasons for the increase in investor value and demonstrated that the extremely high investor returns are an inordinate outcome given the changed economic conditions since passage of the Act.

Current Financial Analysis

Evaluation of the rate of return on equity earned by Exelon and its market to book ratio.

A standard way to compute whether rate levels are fair to investors and consumers is to compare the earned profit level with returns that have typically been granted by regulatory commissions to other utilities. The manner in which ComEd has accounted for its generating plants means that one can no longer do this sort of analysis using ComEd financial reports alone. ComEd and Exelon have made a series of accounting adjustments and engaged in corporate restructuring that prevent a standard financial analysis of profits received from distribution, transmission and generation at the ComEd level.

Exelon's accounting policies make it virtually impossible from available data to put the generating and distribution pieces of ComEd back together and to measure its earned return on equity on a stand-alone basis. For example, when the Company sold coal plants it deferred the gain against its nuclear investment; it recorded regulatory assets related to recovering costs for its nuclear plants; it stopped reporting generating plant costs to FERC; it recorded goodwill associated with the PECO merger at the ComEd level; and it merged its generating plants with PECO plants, making it impossible to track the profits earned from selling power in Illinois.

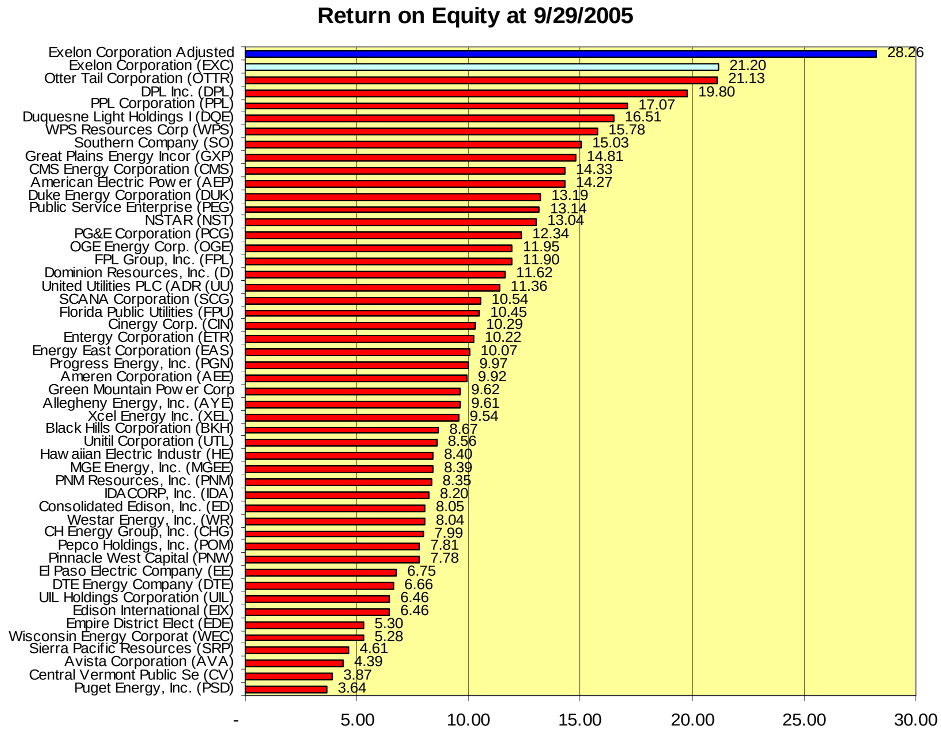
Given the problems with measuring profits that ComEd has realized from distribution, transmission and generation on a stand-alone basis, the study analyzes the financial performance of Exelon on a consolidated basis. Even though this means that the analysis covers both ComEd and PECO, a consolidated analysis makes sense because the overwhelming majority of Exelon's assets, revenues and costs come from assets that were owned by ComEd or PECO and were once subject to price regulation. At the end of the day, if Exelon is earning larger profits since it restructured, it is because the rates of ComEd and/or PECO exceed distribution, transmission and generation costs.

Comparative analysis of Exelon relative to other companies in the industry demonstrates that it has realized exceptional financial performance. Two of the basic measures of the financial strength of a utility company are the ratio of net profit to equity – the ROE – and the ratio of the stock market valuation to the equity investment – the market to book ratio. The return on equity is the single most important statistic in rate proceedings and it drives rate changes for regulated utility companies. Over the past few years, the average rate of return on common equity granted by regulatory commissions has been about 10.5 percent.[8]

The market to book ratio is a basic gauge of whether a utility company is earning a fair rate of return. In theory, rates are set so as to grant investors the minimum profits needed to make an investment. Using the capital attraction principle, a ratio of 1.0 suggests that the earnings are at a level that is just equal to the appropriate level, while a ratio of more than 1.0 implies that earned returns exceed the return necessary to attract investment. If the amount that investors are willing to pay for a stock exceeds the original investment – the market to book exceeds 1.0 – then prevailing profit levels exceed the amount required to raise the investment.

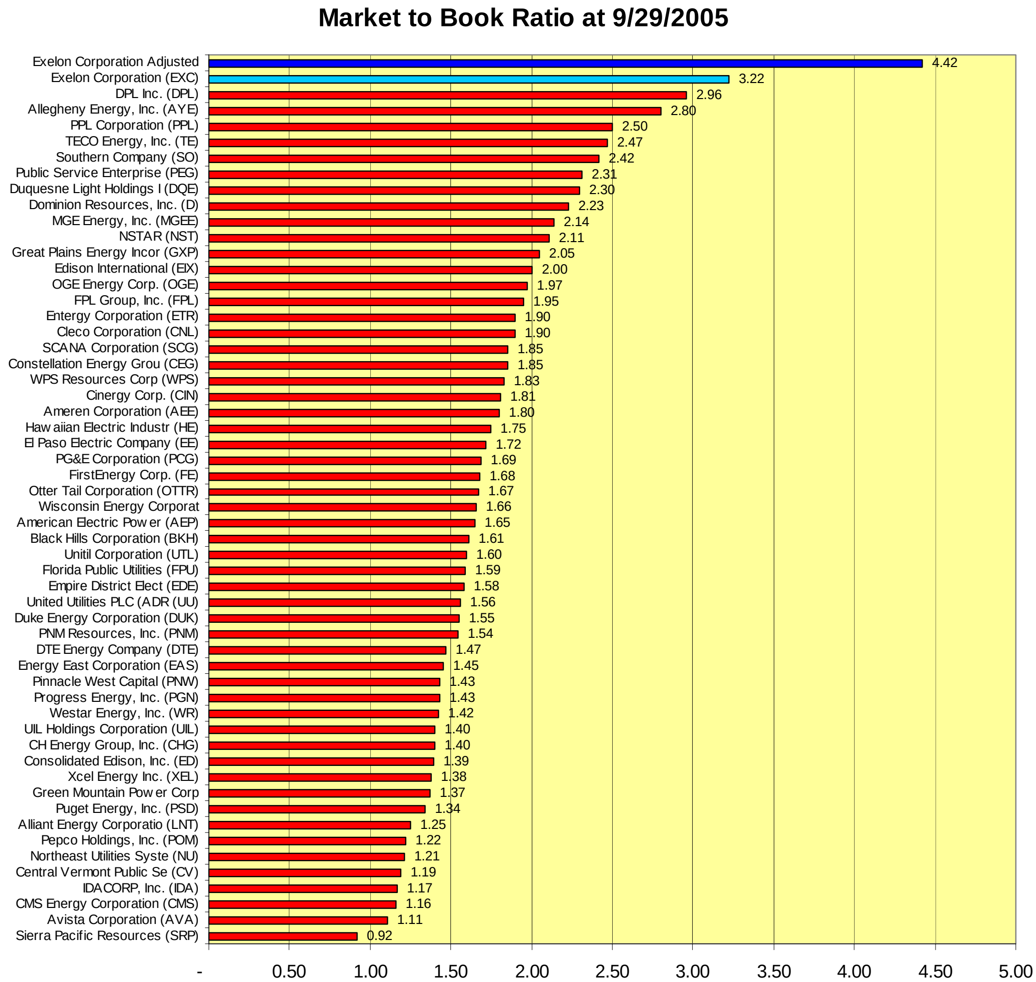
The study compares Exelon to other companies that have listed shares and are defined to be electric utility companies by Value Line Investors Services.[9] The ratios for Exelon are shown with and without an adjustment to remove goodwill that was recorded as part of the PECO merger.[10] The adjustment for goodwill is appropriate in the case of Exelon because goodwill increases the equity investment on the balance sheet and it does not represent equity investment. The graph demonstrates that Exelon is now at the very top of the industry in terms of market to book ratio and return on equity, as illustrated in the two graphs below.[11]

[8] The average return granted by regulatory commissions is included in the testimony filed by ComEd as part of its delivery services case.
[9] The source of the data is yahoo.finance.com. Adjustments have been made for companies that only own utility generation, for foreign utility companies and for companies that have had large write-offs. The ROE graph does not include companies that have negative or zero ROE.
[10] The basis of the adjustment is from the testimony of Exelon's chief financial officer, who stated that if the merger accounting adjustment did not occur, common equity would be higher by $2.92 billion. The adjustment affects the denominator of the ROE calculation and the market to book ratio.
[11] If the market to book ratio is equal to 1.0, then a utility is just earning its cost of capital; if the market to book ratio is above 1.0, the utility is earning above its cost of capital.

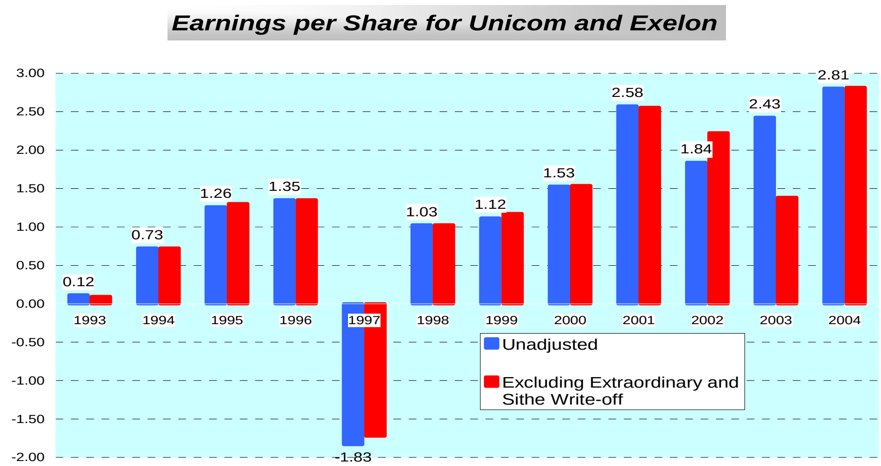


The return on equity earned by Exelon displayed above is almost exclusively derived from the distribution, transmission and generation assets that were formerly owned by ComEd and PECO. This means the return on equity earned by Exelon is a weighted average of the return generated by selling power to ComEd and PECO customers. Since ComEd's sells almost twice as much power as PECO, most of the reason for Exelon's superior return on equity is from prices relative to costs for Illinois ratepayers. The statistics shown on the graph could not occur if ComEd were earning a return similar to other companies.[12]

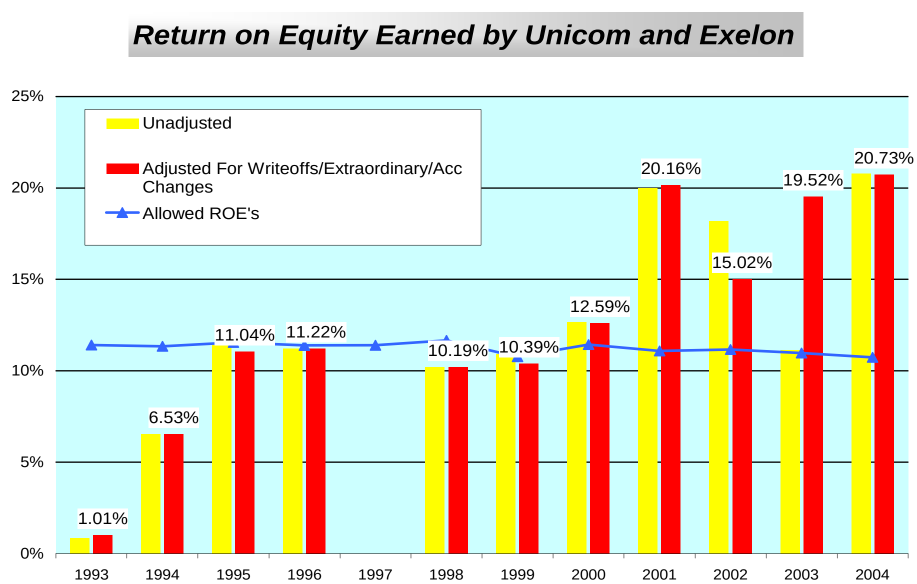
[12] For example, assume that Exelon is earning a 25 percent ROE. If ComEd represents 60 percent of the company and PECO represents 40 percent of the company, then if ComEd is earning an ROE of 15 percent PECO would have to be earning a 40 percent ROE.



The study of Exelon's financial ratios includes analysis of trends in the company's performance over time as well as the comparative analysis at a single point. The earnings per share analysis shown on the graph below demonstrates the amount of earnings generated by Unicom and Exelon relative to shares outstanding. The graph illustrates, that since 2001, Unicom shareholders have realized more than double the income relative to each share owned (earnings per share) than they earned on each share before 1999. This growth in earnings explains why stock prices have increased by such an extent in the past few years. (The adjustments that differentiate the two bars are related to the Sithe write-off of plant and accounting changes).



The trend in earned return on equity has been similar to the trend in earnings per share. After the merger and the transfer of generating plants, the return on equity for Exelon doubled, as shown in the graph below which compares Unicom/Exelon earned returns to returns with those that were granted by regulatory commissions over the same period.[13] (The very high returns on equity shown on the graph below are understated because of the goodwill that was recorded at ComEd when the merger occurred.) Even without adjusting for goodwill, Exelon's return on equity has increased from the 10-11 percent range to more than 20 percent. It is now more than double the level of returns granted to regulated utilities.



[13] To evaluate historic returns we used Unicom and Exelon financial statements from before the Act was passed. In evaluating the historic performance, we adjusted the historic shares that were outstanding for Unicom to reflect the exchange ratio in the merger and the Exelon stock split.

Prospective Financial Condition

Financial projections of Exelon's performance at various rate levels

To assess Exelon's future financial position, a detailed financial model has been developed to project the company's performance under various ComEd rate scenarios.[14] The rate scenarios include:

- Market Rates for power plus delivery charges. The market rates begin in 2007 at 4.2 cents per kWh and increase to 5.13 cents per kWh by 2012. Delivery service rates are assumed to increase by 15 percent relative to current levels.
- Rates paid by all customers remain at 2004 levels.
- A residential rate reduction of 5 percent in 2007 and frozen rates for other customers at 2004 levels.

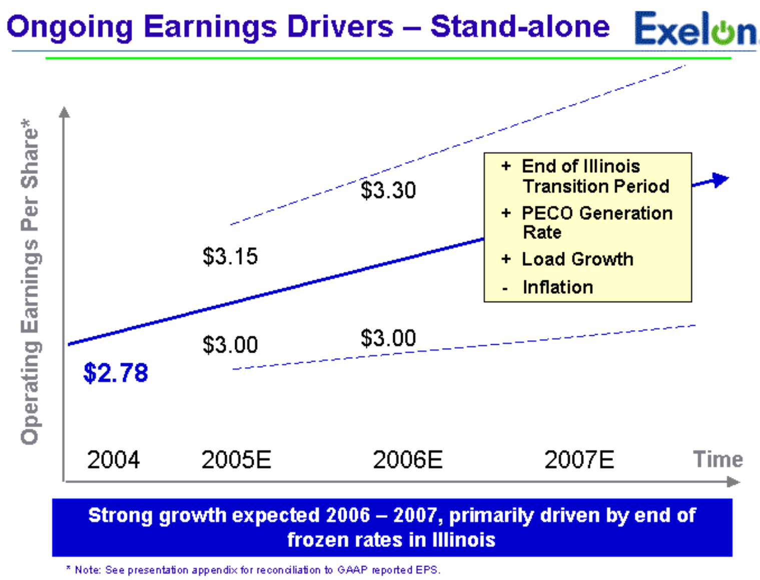
The model uses historic data, Exelon analyst presentations, Exelon earnings guidance, forward electricity prices in the PJM market, energy usage data, prospective delivery service rates and other factors to project Exelon's financial statements.

Components of the model include ComEd retail electric revenues; ComEd operating costs; PECO retail electric and gas revenues and costs; Exelon Generation wholesale revenues; Exelon Generation fuel, purchased power and other costs; Exelon corporate overhead; Exelon debt costs; Exelon financing and taxes; and Exelon capital expenditures. ComEd retail revenues are computed through adding the delivery charge rates from the ComEd delivery charge filing to market rates. Loss factors are included as are transmission costs and other ancillary items. The residential rate increase is sensitive to the market price for power and the delivery charge rate increase. Assuming a market price of 4.2 cents per kWh and ComEd's proposed delivery charge rates, the revenue increase realized from residential customers is about $500 million.

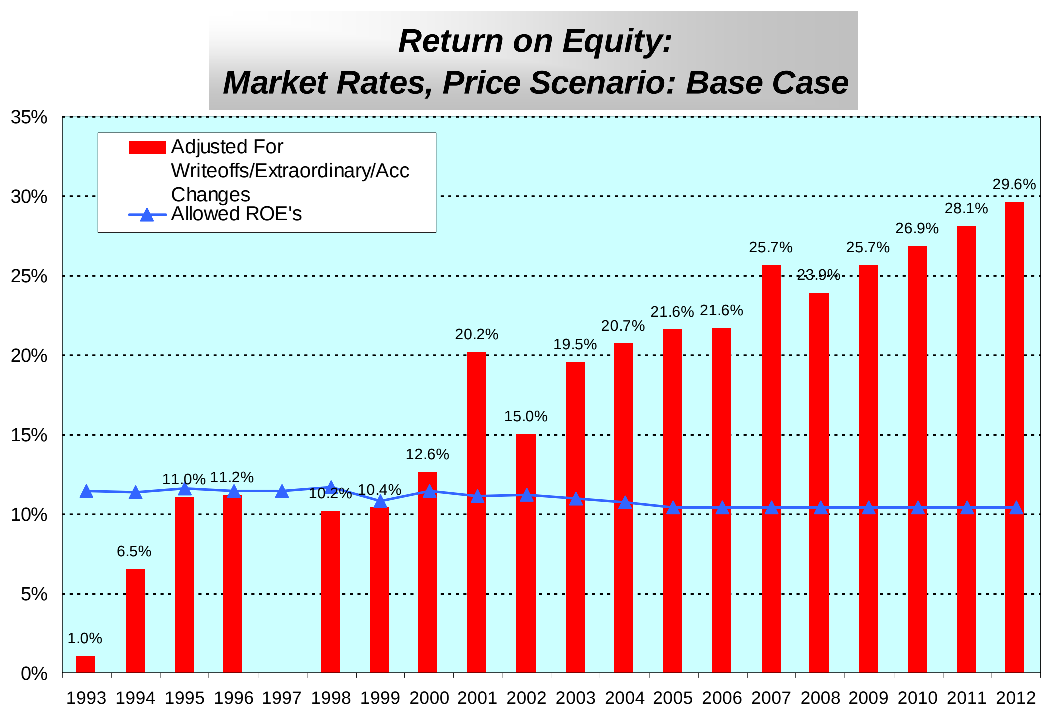
Other aspects of the forecast involve determining the amount of power that Exelon will have available to sell in wholesale markets and the price of that power. The study uses information from Exelon on the amount of capacity it owns and the historic amount it has realized from selling surplus power to evaluate the future profits on selling power. In order to assure that the model is calibrated to Exelon projections, the forecasts are calibrated to earnings guidance provided by Exelon.

Before describing the results of these forecasts, it should be emphasized that Exelon itself has touted the importance of rate increases in boosting its earnings. The chart below, taken from Exelon's September investor analyst presentation, demonstrates that the company's primary point of emphasis in projecting improved future earnings is the end of the rate freeze – see the comment in blue below the graph that earnings growth is "primarily driven by the end of frozen rates in Illinois."

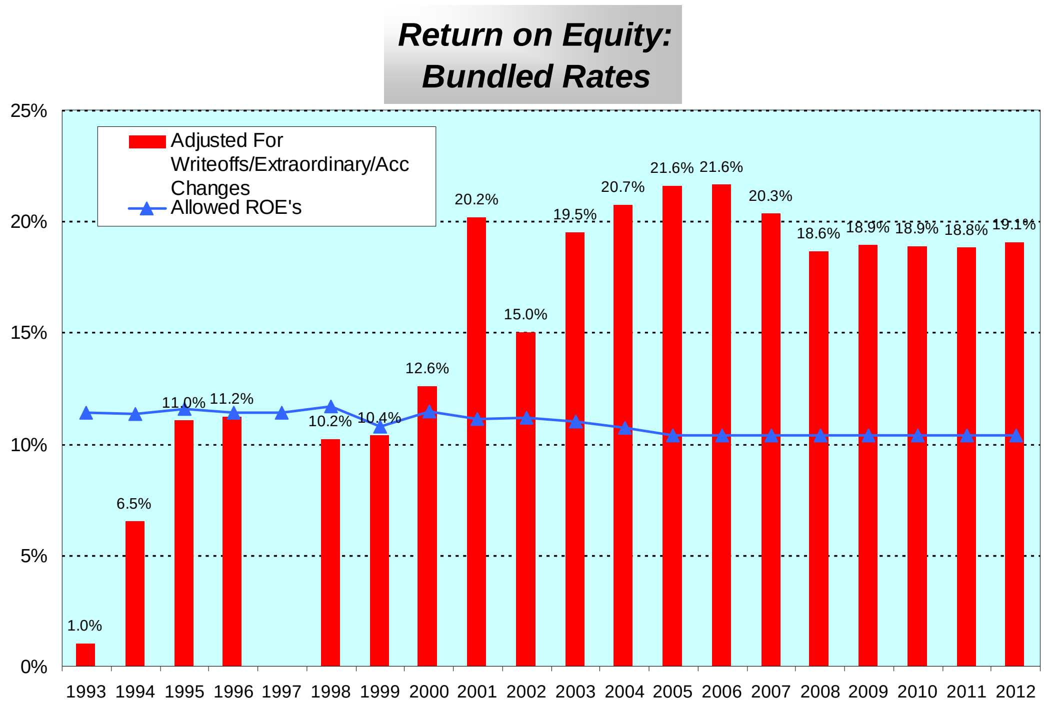
[14] The forecast looks through transactions between Exelon Generation and the distribution subsidiaries. The total revenue from ComEd and PECO are computed from energy sales, market prices and delivery service rate increases. The production costs are derived from an analysis of energy production from nuclear plants and other sources. The forecasts also incorporate earnings guidance published by Exelon.

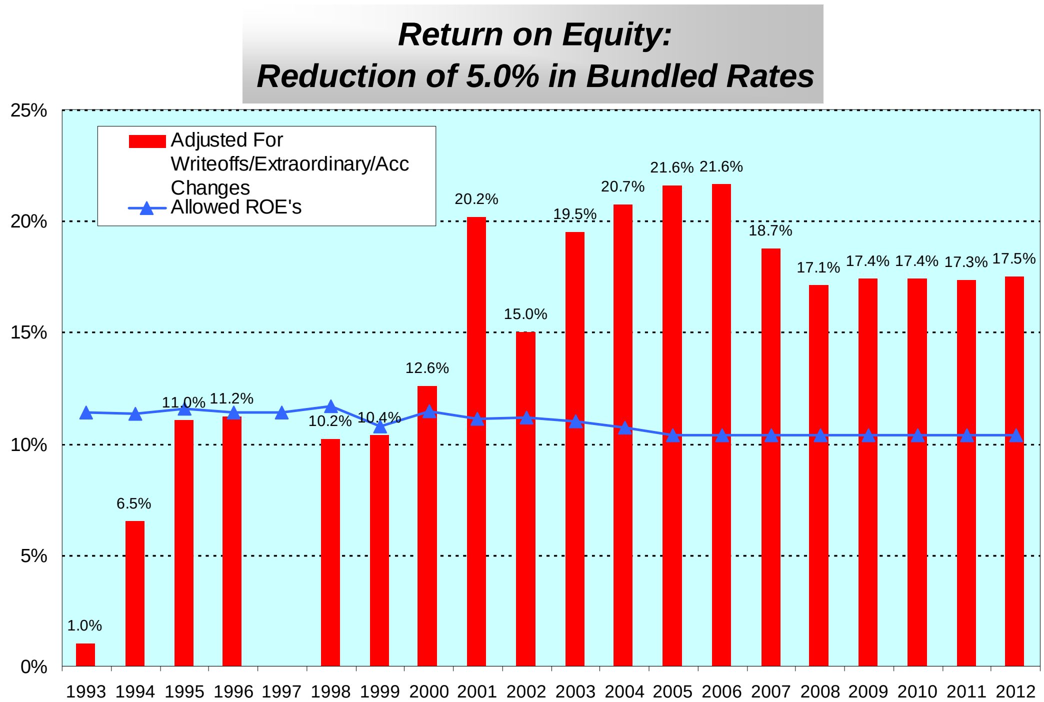


The forecast predicts that the return on equity will increase over and above the current record levels. This is not surprising because Exelon will realize increased revenues from any future rate increase while its operating costs do not change very much. Further, Exelon has surplus nuclear power to sell in the Midwest (it has about 33 percent more power than it needs) which means it profits with higher energy prices. The return on equity earned increases to by a few percentage points and eventually reaches 30 percent as shown on the graph below.



For purposes of this study, the final analysis performed was an evaluation of what would happen to Exelon's return on equity if the rate freeze remains in effect and if residential rates are reduced by 5 percent in 2007. This analysis demonstrates that the return on equity would remain in the 20 percent range through 2011 if rates remained at their current levels, far above any reasonable estimate of the cost of equity for a utility company. In addition to the scenarios shown below, analyses were performed for a multitude of different market price and other assumptions. In all of these scenarios, the result is the same, namely Exelon will continue to see robust earnings without any additional rate increase from consumers.





The study of Exelon and ComEd finances illuminates that the company's strategy revolves around manipulating the regulatory process. Exelon's strategic objectives have very little to do with achieving benefits from efficiency in free markets, and more to do with juggling who pays the cost and who receives the benefits from investments in nuclear plants. Illinois is facing historic decisions with respect to the pricing of electricity and policy makers must account for the financial condition of Exelon.